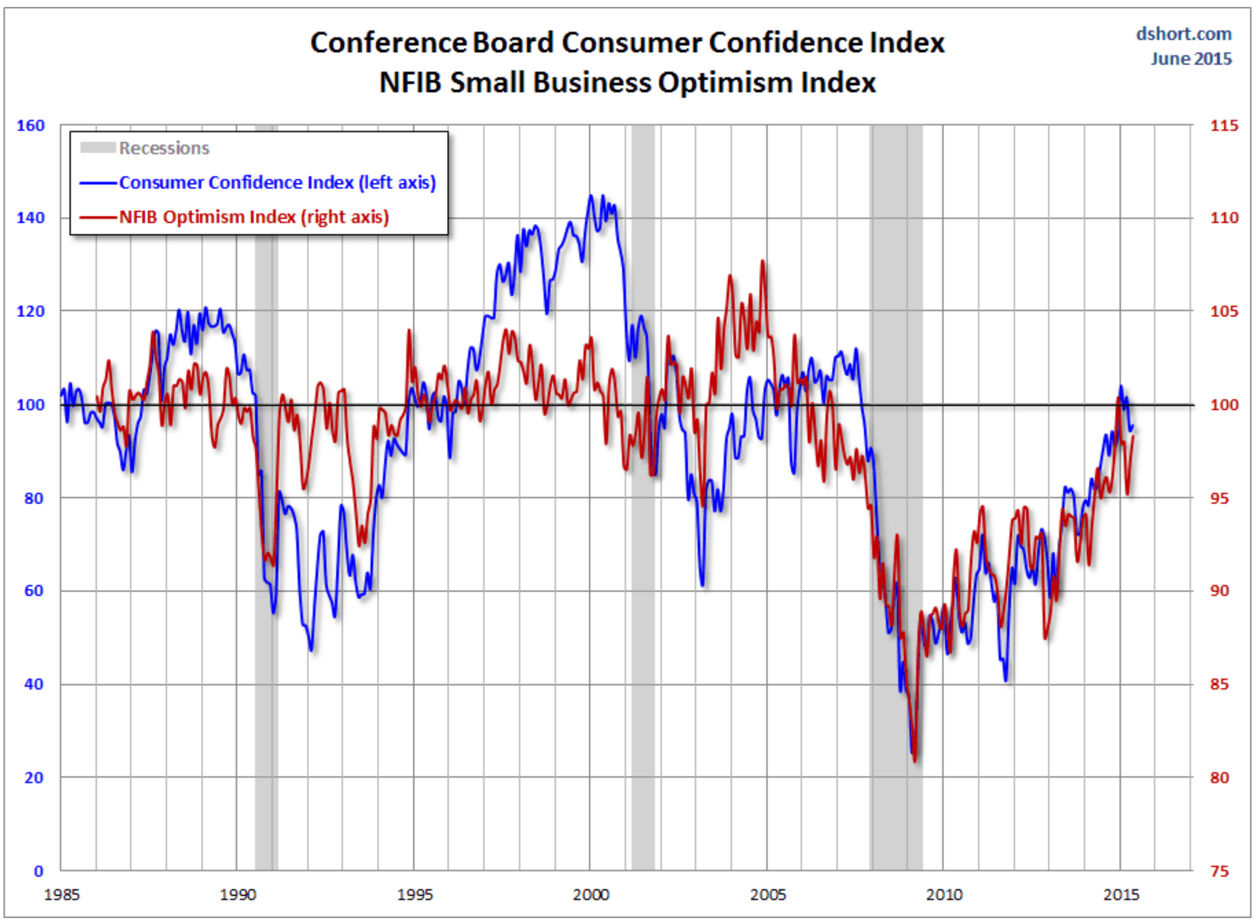
Second Quarter 2015

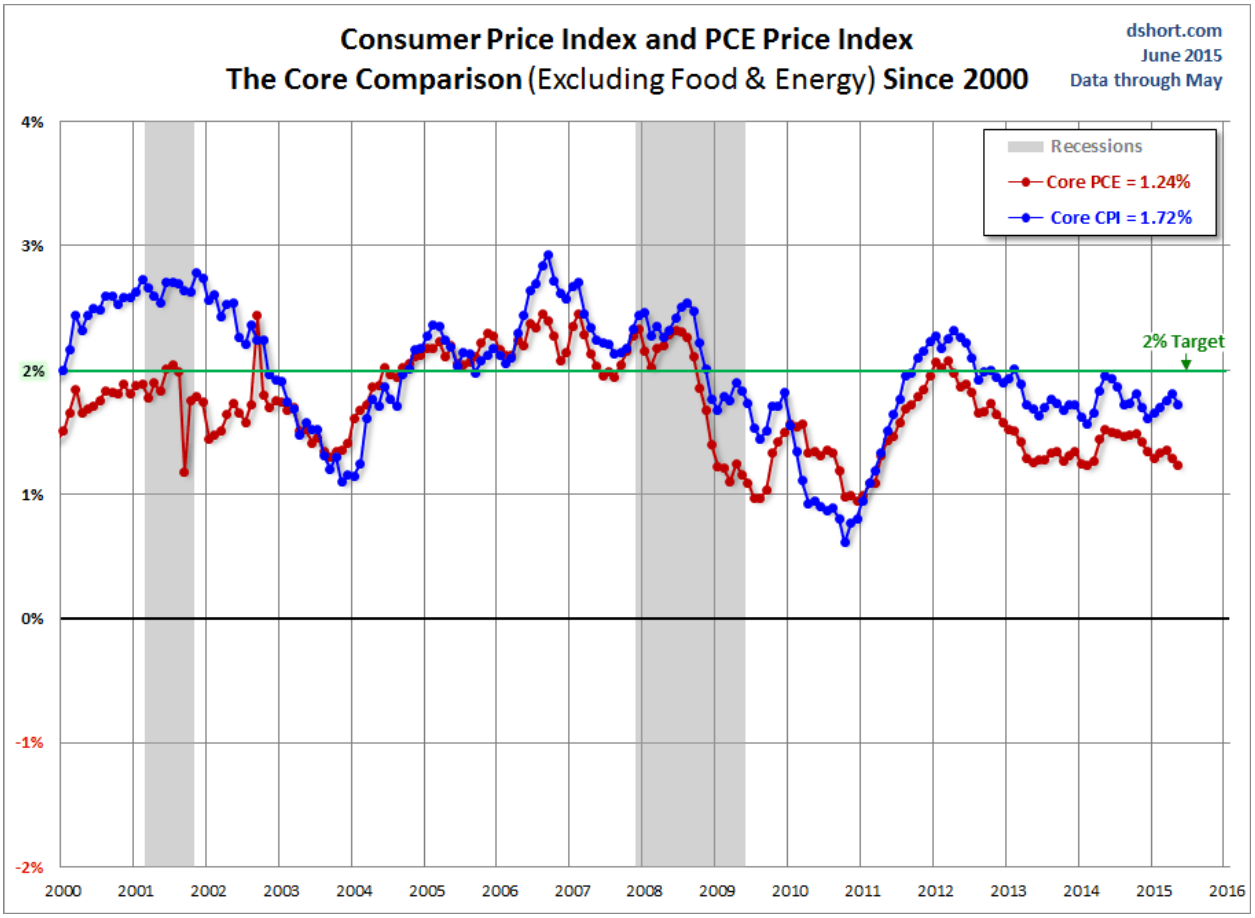
US Economy

The US economy continues to plod along. The third and final estimate for real Q1 2015 GDP came in at -0.2% (annualized growth rate). This compares favorably with real Q1 2014 GDP at -2.9%. The first quarter is usually the weakest due to winter weather issues. The second quarter numbers won't be available until July 30. The latest Conference Board Consumer Confidence Index improved further in June after a modest gain in May. The NFIB Small Business Optimism index is also near recent highs and as might be expected, closely follows consumer confidence (see chart below).



Another important economic data point is the rate of inflation. The U.S. Federal Reserve (Fed) has two primary responsibilities: managing unemployment and inflation rates. Both significantly impact economic performance. The best-known inflation indicator in the U.S. is the consumer-price index (CPI), a measure of the average prices paid by consumers for a common basket of goods and services that serves as a barometer of economic health. The Fed prefers to use the Personal Consumption Expenditures Index (PCE) which like CPI, tracks changes in real prices but it includes all goods and services consumed in the US whether they are purchased by consumers or corporations or governments for the benefit of consumers.

PCE came to the fore recently when the Fed opened the door to raising interest rates later this year. The central bank has kept interest rates low to encourage borrowing and spending, which typically causes inflation to increase. But the PCE has been below the Fed's target of 2% for more than two years[1]. At the end of May, the core PCE (excluding food and energy) was 1.24%. Including food & energy, PCE was 0.22%. By these measures, high inflation is not likely to be a problem in the near future.



On the US jobs front, the unemployment rate fell from 5.5% to 5.3% in June. This drop was driven by a larger decline in the labor force (432K) than the reduction in the unemployed (375K)[2], but nonetheless is a positive print.

All in all, our economy is still growing and many of the data points are positive. However, the growth is tepid and the low inflation is concerning. Because our economic growth and inflation

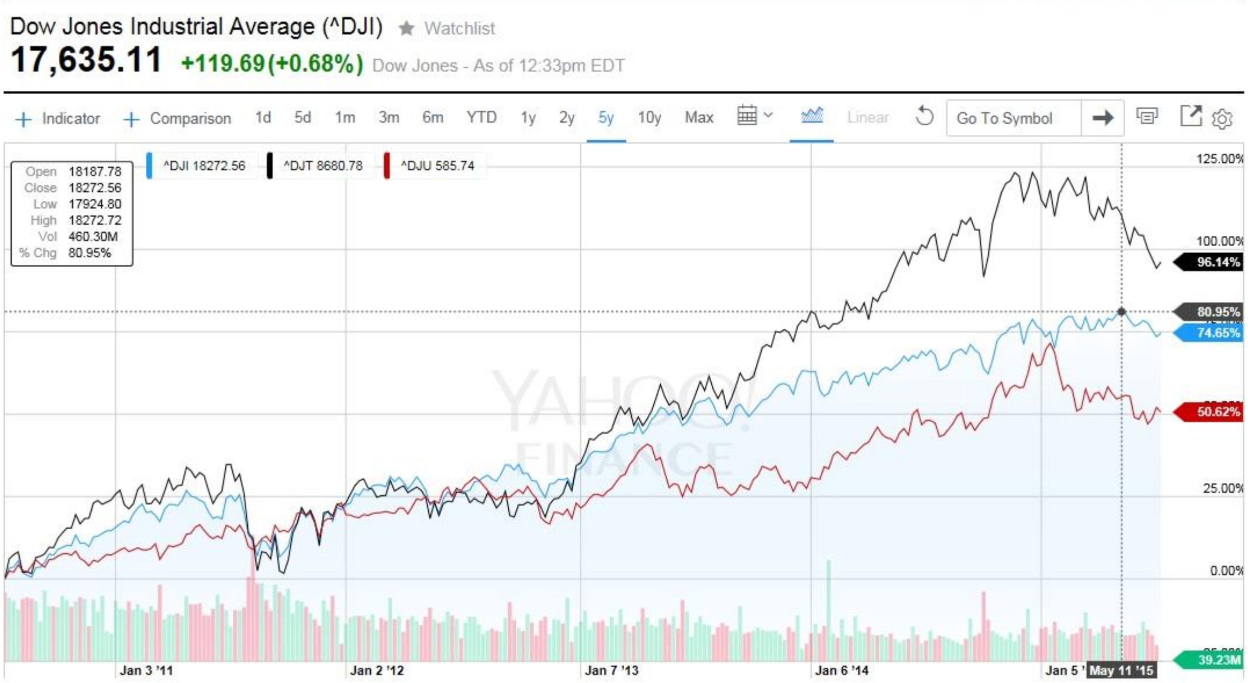
[1] Information regarding CPI and PCE from the Wall Street Journal 3/20/2015.
[2] From dshort.com, 7/2/2015 - June New Jobs

are low, there is not much buffer between expansion and contraction. Global deflation is still a possibility and we will continue to be watchful.

Capital Markets

US stocks indexes were generally flat in Q2 and all but small caps were negative in the month of June. Globally, virtually every stock market had a tough June including both developed markets (Japan, United Kingdom, Canada, etc.) and emerging markets (China, Korea, Russia, etc.). Similarly, bonds were negative in the second quarter and June with the exception of short duration quality bonds. US market valuations are still stretched and as discussed in past newsletters, the general markets offer low prospective returns.

We are starting to see some warning signs that the US stock market may be topping. Of note is the fact that not all key US stock indexes are in sync. As shown below, through the end of 2014, the Dow Jones Industrial Index (DJI), the Dow Jones Transport Index (DJT) & the Dow Jones Utility Index (DJU) were all in rising price trends. Since January 1, while the DJI continued higher, the price performance of the DJT and the DJU diverged and declined -9.8% and -14.7% respectively from their highs, through June. In the first week of July, the DJT & DJU divergences have been followed by a rollover in price of the DJI. This warning has been reinforced by a risk-off indication in our 100 day moving average of the S&P 500 price. A further warning has occurred in our bond model.



It must be noted that these market "warning signs" are not definitive nor are they infallible, but they have proven to be prescient in the past.

Portfolios

We are advocates of a three-pillar investment approach. The 3 pillars are:

1. Stocks (US, International, Emerging),
2. Bonds (US, International, Emerging; government, mortgage & corporate) and
3. Alternatives (non-correlated strategies, real assets, commodities).

The allocations to each pillar will vary depending on an individual's risk tolerance and return objectives as well as market conditions. As discussed in the economic section above, the US economy has yet to truly breakout with strong, sustained growth. A deflationary outcome is still a possibility and one which would be harmful to stocks (although probably beneficial to bonds). A key benefit of the 3-pillar approach is its capacity to protect and grow wealth in a variety of market conditions. The 3 pillars provide diversification and in particular, the Alternatives provide diversification which is uncorrelated to stocks or bonds.

During the second quarter, the third pillar was our best performer with overall positive results from alternatives including the managed futures funds and in particular an exchange traded fund (ETF) which invests in grains (corn, wheat & soybeans). Japan and gold stocks were also positive contributors to performance. The main detractors were energy stocks and cheap countries, both of which we believe have exceptional long-term return prospects.

The "risk-off" warnings described in the Markets section above caused us to reduce exposure to equities by approximately 10% in our Growth portfolio. If we get additional "risk-off" warnings, we will further reduce our stock exposure. If the warnings dissipate and our indicators suggest that risk is on again, we will increase our exposure to stocks.

Thank you for your continued trust and support.

Trevor Holsinger & Steve Small

Disclosure:

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